

ANNUAL REPORT AND FORECAST ROMANIA IN 2006

Edited by

ROMANIAN ACADEMIC SOCIETY



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Summary

The analysts of the Romanian Academic Society (SAR) argue that 2006 will be a rather good year from the economic point of view, with a further reduction of the inflation and of the account deficits and with a reasonable economic growth. Since the beginning of the year, the trend of accelerating reforms has been noticeable, especially in the fields of justice and anti-corruption, trying to avoid the activation of safeguard clauses and trying to convince the European Union that Romania is prepared for accession. Clearly, in 2006 Romania has a healthier economic environment compared to 2004. In addition, media, civil society and recently even the Prosecutor's Office are much more active in exposing high-level corruption. Our report makes forecasts on the economic evolution, it discusses the recent positive developments in the field of justice and anti-corruption fight but also deals with other consolidated aspects that risk to affect the performance of Romania during and after accession. SAR analyses the capacity of absorption of EU funds and transparency of the administration. The recent survey conducted by SAR shows that the performance of the administration increased compared to 2003 but this increase features just in quantity and it is rather chaotic instead of a qualitative and planned improvement. Many public bodies lack awareness on the difficulties likely to arise when dealing with a growing level of European funding. Without a significant political effort targeted at increasing the capacity of the public administration, Romania will face a considerable risk to end up using just small amount of the funds allotted by the Union. We actually risk failing a new Marshall plan, much more generous than the original one, because of the insufficient capacity of our administration.

FORECASTS

SAR interviewed in February 2006 its usual panel of economists¹ on the most important developments this year will bring. Some open questions regarding the significant trends in the Romanian economy were included as well. This introductory section presents a brief summary of the answers received.

MAIN MACROECONOMIC INDICATORS FOR 2006

	<i>Average</i>	<i>Margin (min-max)</i>
GDP Growth, %	<i>4.6</i>	3 – 5
Inflation Rate, %	<i>7.1</i>	6 – 8
RON/Euro Exchange Rate on 31 Dec 2006	<i>3.48</i>	3.42 – 3.65
Account Deficit, %	<i>8.2</i>	7 – 9.5
Budget Deficit, %	<i>0.8</i>	0.5 – 1.5
Stock Exchange Index Raise BET, %	<i>28</i>	20 – 35

One general remark we can make is that our panel, whose members are more or less the same as last year, was very cautious in issuing forecasts. Natural disasters slowed down the economy unexpectedly last year, which contradicted some of our forecasts for 2005: the growth was under 5%, as opposed to the 6.2% average forecasted by us in January 2005; the stock exchange index BET only rose by 51%, as opposed to the average forecast of 62%. On the other hand, we should mention the fact that SAR forecasts were, nevertheless, closer to the real values than other forecasts issued at the time, for instance those provided by EIU. Moreover, we

¹ We are grateful to the following experts for accepting our invitation to take part in the panel: Lucian Albu, Institute for Economic Forecasts; Bogdan Baltazar, Baltazar, Bloom & Pîrvulescu; Radu Crăciun, senior analyst ABN Amro; Florin Cîțu, chief economist, ING Bank; Daniel Dăianu, professor, AES; Aurelian Dochia, general manager, SGG corporate finance; Cătălin Păuna, economist, World Bank Mission; Florin Pogonaru, president, Association of Romanian Business Owners; Ilie Șerbănescu, economic analyst.

guessed the inflation rate right, and we were more pessimistic about the budget deficit than it turned out to be, in the end.

This year, as one of the panelists told us, we started from a more reserved assumption, in that we are expecting hindrances on the way: the weather may play tricks on us, bringing damages to the agriculture and infrastructure; power prices may rise again, which was not carefully considered last year. And, having in mind this new trend among the commentators and entrepreneurs, one should take the figures in the table for a minimum threshold of economic performance, against which we may measure surprises as higher, rather than lower, indicators, although nothing can be ruled out.

Another remarkable difference from last year was that the forecasts became closer and closer to the average, which is a sign that expectations have stabilized and the climate has become less unpredictable, in other words we have a more stable economy. Except for 2 of the 9 panelists, who are more pessimistic about the growth, the GDP prediction is for a 1% raise against last year's figures: somewhere between 4.5 and 5%. Everybody agrees, however, that the inflation rate will be higher than forecasted by the NBR, our average for 2006 being 7.1%.

With only one exception, the panelists expect a small appreciation of the RON to the Euro, and the exchange rate at the end of 2006 is forecasted to be 3.45. SAR recommendation in this respect would be to continue to rely on the leu for savings or investments. But, not so much in bank deposits, because the interest rates will continue to be low, sometimes lower than the inflation rate. A better choice is the capital market: the BET index is forecasted to have an average raise of 28%. If you choose your portfolio right, this figure is easily achieved.

Finally, the gap between the budget deficit (low) and the account deficit (high) shows that. Just like last year, Romania's weakness doesn't necessarily lie in the governmental expenditure but, rather, in the poor economic performance, which cannot provide the products demanded by the domestic market and encourages the increased imports. However, the economy has become more and more diversified over the past years, so, perhaps, this global judgment is too narrow: there are many kinds of imports, and some of those bring productivity; on the other hand, a more efficient work and more value added on the labor unit, although desired and set as objectives by everybody, are sometimes blocked by policies, for social reasons.

What do you anticipate would be the main economic issue the government will have to face in 2006?

This open question gave more varied answers this year: the 9 panelists can hardly find 2-3 common ideas in this respect. The pessimistic interpretation of this situation could be that there are more and more economic issues that the government has to face. The optimistic interpretation would be

that one of these issues is so serious and imminent to trigger an automatic and unanimous answer. Depending on their line of work, each of the panelists sees other issues as the most important. In other words, in connection with what we said before, the Romanian economy becomes more and more diversified, although some of the imbalances still linger on. The answers we received suggest that the issues can be grouped on two categories:

Emergencies / short term:

- Balance of trade deficit, because of the rise of imports;
- Inflationist pressures and the wide hedge between the passive and active interest rates; the actually negative interest rates;
- Controlled salary increases in the public sector.

Medium term:

- The rise of power prices and salary increases, combined with the relative stability of the foreign exchange rate will lead to competitiveness problems for exports;
- Economic growth slowing down because of export drops;
- Very slow start of the large infrastructure programs, more talked about that implemented up to now;
- A difficult collection of the GDP percentage to the budget, which may lead to a raise of the main taxes (VAT or income/corporate income tax).

What do you think will be the most important changes brought on by the review of the Tax Code, programmed for January 2007, as compared to the current situation (February 2006)?

As opposed to the first question, there is some convergence as to normative issues in the experts' opinions: everybody agrees that the Government's priority should be the increased collection of revenues to the state aggregated budget as a percentage of the GDP, by at least 3-4% over the current 30%. This situation is triggered by the need to allocate matching funds for the pre- and post-accession programs, as well as other domestic policies needed in order to come in line with the *acquis communautaire*.

As for what will really happen, the panel members have various opinions:

- About half of them believe that one of the large taxes will rise: they think it would be the VAT, although it would be possible to bring the flat income tax up to 18% (where it should have been placed, together with the corporate income tax, from the very start, just as one of the analysts commented, adding that the very low rate of 16% was not reasonable and rather considered it a blunder). Another urgent matter is the expansion of the tax base for the personal income tax, by including incomes from agriculture (and, probably, high pensions). Some see these measures taken until 2007 – therefore a review of the Tax Code this year; other believe these measures must be part of a

long term strategy, correlated with the investment strategy, which should be considered for at least 2-3 years.

- The other panelists also consider that the large taxes should be raised, but they don't believe the current government will be determined enough to do it, at least not in 2007. It is possible, however, perhaps in order to balance this indecision, but not necessarily, to have a 2006 Tax Code review which will change some of the smaller taxes (property, vehicles) and introduce new ones (environment etc.). These taxes won't have a major impact at the macroeconomic level, but will have a significant impact on the administrative sector it is envisaged in: e.g. by increasing the revenues of local governments.

Which is the indicator/element/trend in the Romanian economy you believe is extremely important but not so much mentioned nowadays?

Surprisingly enough, the answers to this questions which is the most general of the set, are very similar, and they converge towards two topics which are interconnected:

- Structurally and on a long term, there isn't enough talk about **modernization, upgrading**, and Romania's poor state in this respect: lack of infrastructure, energy intensive industries, especially in the utility sector, obsolete technologies in the economy in general, because of the bad industrial inheritance and wrong policies, which discouraged the good quality foreign capital to come on the market (multinational companies). All these elements show a picture of an energy-intensive economy, with low productivity rate, a poor use of the available human capital and, finally, low competitiveness on the foreign markets.
- Circumstantially and on a short term, there isn't enough talk about why, in an economy where consumption rates have exploded and the tax policies were relaxed, Romanian managers are more and more pessimistic and investments have slowed down.

Moreover, another topic which is generally ignored is that of the absorption of EU funds in Romania, which is an indicator, on the one hand, of consistency in governmental policies and, on the other, of a comprehensive measure of institutional capacity in the public and private sector.

ECONOMY

The Romanian economy: what to watch in 2006

The motion of the Romanian economy has been under the spell of two sets of factors lately: one, which, supposedly, fosters structural change -- such factors are changes in relative prices, better governance due to the dissemination of best practices and privatization, etc; and another set of factors that refer to the policy mix and new policy arrangements. Among the latter I range the fiscal policy reform, a further step in the liberalization of the capital account, and inflation targeting (IT) as a new monetary policy regime. A piece of good news is that the investment grade obtained from Fitch and S&P's has not been invalidated despite a very difficult year. Moreover, nominal convergence has been advancing as against new EU member countries. However, there are trends in the Romanian economy which should give policy-makers food for thought and keep them alert; a considerable slowdown in disinflation, sharply rising external deficits, and a drastic cut of the growth of industrial production are ominous. This brief does not undertake a forecast exercise, *par excellence*. Instead, it puts forward a series of issues that would likely impact on the Romanian economic policy and its performance in 2006; it also airs some views on medium term challenges.

1. Supply side shocks and output dynamics

Industrial output has increased substantially less in 2005 than in the previous year; it has risen by a likely 1.8 % while the GDP has probably grown by about 4.0 % for the whole of 2005 (**Table 1**)². Partly, this is to explain by the impact of the heavy and ubiquitous rainfalls and floods of this year. On the other hand, it is plausible to say that Romanian industry and, especially, some of its sectors, have been adversely hit by a series of powerful shocks: the severe appreciation of the domestic currency, the rise in energy tariffs towards EU levels, the cut of subsidies, fiercer competition on internal markets, the lifting of contingencies for European imports of textiles from China (while textiles are a major export item of Romania on EU markets). I would add here the difficulties numerous

² Services and construction have increased considerably faster than industrial output being supported by the booming bank credit and, relatedly, a consumption binge.

indigenous companies have in meeting the requirements of the Acquis communautaire (like in the field of environment protection).

The rise in wages³ has also dented considerably the competitiveness of Romanian output. Calculations which combine the impact of the RON's appreciation and the increase of wages show that the real effective exchange rate (the unit labor cost based REER) has gone up by more than 30% since November 2004.⁴ All this is to say that the more domestic market conditions match those EU wide the harder it is for numerous local companies to comply with the new competition terms. And this has shown up in less growth of output and GDP.

A question comes up easily: how will domestic companies fare in the period to come. Or, to put it differently, has industrial output reached a bottom, or downward adjustment, with its related painful costs, will go on for a while? If the bottom has not yet been reached we may still see some worsening numbers in the months to come⁵; the consumption binge of the last couple of months of the year, with its influence on some industrial sectors and services, may have been misleading in this regard. If this is the case the rise of the GDP in 2006 might be even lower than in 2005 – namely, below the estimate of cca 4%. To a further slowdown of GDP this year could contribute a further appreciation of the domestic currency and new rises in energy tariffs⁶. On the other hand, if its bottom has been reached industrial output may see its growth rise again in 2006, even if signs of it would likely be more visible in the second quarter. A speedier absorption of shocks would help the GDP growth to recover as well, which could also be supported by a better harvest (this year's harvest has fallen by an abysmal 12% as against 2004. More infrastructure work would also help economic activity and the rise in the GDP.⁷

Another note of caution is needed, nonetheless: productivity gains have not been impressive in 2005, which should calm down unwarranted optimism. And capital formation (fixed investment) has not been growing sufficiently in order to become a driving force for GDP growth (instead of consumption) –see table 1⁸. All these uncertainties would place the

³ For instance, in euro terms the rise in salaries of public administration workers and other public sector employees has climbed by more than 40% since October 2004.

⁴ In November 2004 the National Bank of Romania has made the domestic currency float more freely. That made the RON appreciate sharply nominally versus the euro. In the second half of 2005 the RON hovered around 3.6 which suggested that the NBR tried to avoid an "excessive" appreciation of the domestic currency.

⁵ An industrial confidence index calculated by the Group of Applied Economics (GEA) for Q1 of 2006 shows a sobering mood among heads of Romanian companies (Bulletin no.5, Bucharest, February, 2006)

⁶ The RON has gone up already in late February, to below 3.5. This has been prompted by a tightening of monetary policy (the rise in the policy rate to 8.5% from 7.5%) and resulting inflows of speculative capital..

⁷ The Government has announced a substantial boost of funding for infrastructure in 2006, but, apart from the Brasov-Bors highway, none of the other announced projects are likely to start in the first half of this year.

⁸ Gross fixed investment can also be misleading because it does not separate investment in new buildings from that in new equipment and machinery; the former has registered a massive increase in the last few years..

growth of GDP this year within the range of 3.5-4.5%, with a more likely outcome toward its lower end unless the harvest is substantially better than in 2005.

Over the medium term a lot hinges on productivity gains, which, themselves, depend on deepening structural change (improved financial discipline, better management, more investment and absorption of new technologies, etc.). In this context it is commendable that the share of R&D expenditure in the public budget has gone up to 0.4% of GDP this year, as against 0.27% in 2005; this figure is projected to increase to 0.7% in 2007. Companies, themselves have to invest more in R&D and the absorption of new technologies.

Table 1: Key macroeconomic indicators

	2003	2004	2005*	2006**
Real GDP growth (%)	5.2	8.3	4.0	3.5-4.5
CPI(Dec.on Dec, %)	14.1	9.3	8.6	6.5-7.5
Unemployment	7.2	6.2	6.1	
Current account deficit, % of GDP	-6.0	-8.7	-9.2	(-9.0)-(-9.2)
Public budget deficit	-2.3	-1.1	-0.8	(-0.5)-(-1.0)
Total saving, %GDP	16.9	14.3	13.0	
Gross domestic investment, % of GDP	22.9	23.1	22.2	
NBR interest rate(end of period), %	23.4	18.8	6.7	
Reserve cover of imports	3.8	4.0	5.7	
Total external debt	34.1	36.3	34.5	

Sources: National bank of Romania, IMF data, and own projections

* estimates, ** forecasts

2. External deficits

The trade deficit has continued to expand quite rapidly, by almost 40% as against 2004; it has exceeded 10 billion euro in 2005. The rapid expansion of bank credit and the RON's appreciation have played a major role in this respect. The current account deficit went up to almost 6.8 billion euro in 2005, that is about 9.2% of GDP.

The external deficits have been the outcome of a combination of supply side and demand side shocks; whereas the supply side shocks (as outlined in section 1) have slowed down industrial output the demand side factors

(among which the booming bank credit, the flat tax and wage rises in particular) have driven consumption upwards.

The booming credit has, arguably, been the main factor behind the rise in external deficits. Large credit expansion has been occurring in all European emerging economies in recent years. These economies are under-banked, profit margins are exceptional by EU standards, and EU accession is perceived as an anchor that boosts policy consistency and performance over time. These reasons are powerful enough to explain the upsurge of bank credit and, because of it, the growing trade and current account deficits. Moreover, the big share held by non-governmental credit in the growth of current account deficits (in Romania this share has gone up to almost 90% lately) cripples the traditional IMF recipe for dealing with external deficits⁹; diminishing budget deficits, or even achieving surpluses gets easily in the realm of inefficacy under the circumstances –when, in addition, there is liberalization of the capital account, which is a precondition of EU accession.

Given that the GDP and the industrial output growth have slowed down significantly last year a question is begging for an answer: are such external deficits sustainable? As a matter of fact, there are several intertwined aspects related to the rise in external deficits which ask for clarifications. Thus, the unimpressive productivity gains of the economy, this year, seem to confirm the qualms I expressed, a couple of years ago, regarding a competitiveness challenge; more precisely: the ability of the economy to cope with a sharp exchange rate appreciation following the heavy money inflows from Romanians who work abroad and other capital inflows which are attracted by Romania's prospects to join the EU (a sort of a *Dutch disease*¹⁰)¹¹. Some would argue that the external deficits are not worrisome in view of the "normal" growth of bank credit and the presence of foreign capital in the banking industry that would, presumably, extend reliable long term credit lines to their Romanian outfits. But such arguments have their own limits; in the real economy there is no one way street; painful corrections are inevitable at one point in time were deficits to exceed certain thresholds¹².

Were such a correction to happen, it would involve a severe depreciation of the exchange rate that could rekindle inflation and put some non-

⁹ This a lesson amply illustrated by the crisis in South East Asia in the second half of the last decade.

¹⁰ The Dutch disease refers to a bonanza which bestows a country; this bonanza, entailed by rapidly expanding exports of natural resources (oil, or gas) would lead to an excessive appreciation of the domestic currency that would hurt manufacturing exports considerably.

¹¹ Daianu, "Are we threatened by a *Dutch disease*?", Ziarul Financiar, June, .2004. See also D.Daianu and Ella Kallai, "Disinflation and monetary policy arrangements in Romania", William Davidson Institute Working Paper, November 2004 and in K.Liebscher et.al (ed.), "European Economic Integration and South East Europe", Cheltenham (UK), Edward Elgar, 2005, pp.135

¹² For the current account such a threshold may be around 9% in view of current and anticipated stable capital inflows (including FDI). But such thresholds are more theoretical, for they can change as conditions do.

negligible strain on bank balance-sheets. And keep in mind that disinflation is not yet solid enough. Hopefully, investment would pick up and new technologies would bolster the competitiveness of our firms. Since the vulnerability indicators of the Romanian economy (table 2) are in a good shape a worse case scenario would more likely occur over the medium term. But even then, an implosion in the banking sector is hard to contemplate now.

Although vulnerability indicators seem to preclude a short term accident this is no reason for complacency. Policies have to stay prudent in 2006 and in the following year. What has to be watched carefully here is the effectiveness of tight budget and monetary policies when bank credit is rising so rapidly. As I have stressed already, betting on budget policy to control external deficits is devoid of much sense when the capital account is free and bank credit extinguishes any significant crowding out effect. But this does not mean that budget policy has the leeway to be relaxed. There is an asymmetric policy efficacy at work here. The budget deficit in 2006 is also presented within a range (-0.5, -1.0) as its current construction is questionable (some revenues are overestimated and some expenditure underestimated).

Needed policy corrections at one point in time may prove to be quite painful under such circumstances. Hopefully, the expansion of bank credit would relent in the not too distant future and help the NBR and the Government to avoid measures that could provoke a recession as a means to correct unsustainable balance of payments imbalances.

Table 2: Vulnerability indicators

	2003	2004	2005*
Total external debt % of GDP	34.1	36.3	34.5
Public sector debt, % GDP	24.4	23.7	19.0
Official reserves/ broad money/M2	45.0	53.0	65.0
Total short term external debt, % of GDP	7.0	8.8	8.1

Sources: Official statistics and IMF data

* estimates

3. Disinflation, wage policy and public finance

After remarkable progress during the last few years disinflation has advanced pretty little in 2005: the end of the year inflation rate has gone down to 8.6% from 9.3% in 2004. Although disinflation has stayed the course in 2005 strong pro-cyclical pressures have put it under jeopardy; the flat tax and high wage rises have increased revenues available to both individuals and firms at a time when internal demand was driving the economy. And the Central Bank, for the sake of discouraging hot money,

has brought down interest rates sharply, a move that has entailed its own risks in terms of discouraging saving and boosting consumption (table 1). Bank deposit rates have become negative in real terms in 2005. It goes without saying that the rise in administered energy prices and speeded up higher excises have played also a major role in slowing down disinflation.

The inflation target was revised twice in 2005: once after the introduction of the 16% flat tax (from 6% as it was stated in the National Development Program (NDP), to 7%), which increased available income to consumers and firms; the second time, in August 2005, from 7% to 7.5%, when the shocks mentioned above moved the revised target beyond reach. The spread of 1.1% above the 7.5 revised inflation target is quite irrelevant for it covers only four months; were it annualized it would be much higher.

The NBR has faced major trade-offs in the last couple of years; one is the attempt to fend off major speculative inflows (which are attracted by interest rate differentials and the appreciation of the domestic currency) with the need to maintain a prudent policy stance in view of the booming consumption. Another trade-off has been the use of exchange rate appreciation as a tool to enhance disinflation vs. the danger of eroding the competitiveness of Romanian production. The Ministry of Finance, too, has been facing major dilemmas; an important one is running low budget deficits (which should support disinflation) while a rise in infrastructure and education expenditure is badly needed; this trade-off has been compounded by the effects of the flat tax. These dilemmas and trade-offs will accompany policy in the years to come as well.

For inflation targeting, as the new monetary policy regime of the National Bank (NBR), the real test would be this year. The last four months of 2005, during which IT has been initiated, are not conclusive. Arguably, it would have been better to postpone its introduction because of the unfavorable features of the domestic monetary transmission mechanism and a series of rises in administered prices¹³. The test of this year will continue to be highly demanding since monetary conditions remain peculiar: almost half of the money supply escapes NBR's control because of euro and dollar denominated transactions; interest rate differentials are still high; the boom of bank credit and capital account liberalization have eroded NBR's ability to control the money supply. As a matter of fact the Central Bank is compelled by these circumstances to pursue, *sotto voce*, other objectives as well, aside from the main mission of bringing inflation down.

The 5% inflation target for 2006 is, practically, unreachable and markets know it. One might say that such a target would help the Government fend off new wage demands and send a strong message about the determination of NBR to stand firm on disinflation; and that disinflation

¹³ For an analysis of the circumstances under which IT is practiced in Romania see Daianu and Kallai (2004 and 2005). See also Daianu, Laurian Lungu and Radu Vranceanu, "Romania's Monetary Institutions and policy: Meeting the EU Challenge", Bucharest, Romanian European Institute, 2004.

expectations would not demur if the 5% target is stuck to. But, there are counterarguments to adopting an over-ambitious inflation target. If this target is hardly credible markets would not buy it and other forecasts (made by commercial banks and IFIs, etc) are likely to be factored in by the corporate world, which would impact on real prices. As a matter of fact, the very February inflation report of the NBR suggests that the inflation for 2006 would likely come close to 6.6%, in the basic scenario¹⁴. This observation, practically, weakens the dis-inflationary power of the 5% inflation target for this year, for it does make sense to individuals and companies to go for the 6.6% number when considering the NBR's forecasts. Likewise, missing the inflation target again (after 2005), by a large margin, would not help bolster the Central Bank's credibility.

An additional key issue is the stance of monetary policy in order to support an over-ambitious target; unless monetary policy, together with budget and wage policies are very tight a 5% inflation target is hardly credible. It can be submitted that a questionable budget deficit target and interest rates which are also geared to discouraging speculative capital inflows would not signal a sufficiently tight policy stance¹⁵. The mentioning of a probable 6.6% inflation rate at the end of the year does not help either in this regard.

The bottom line is that the Central Bank has acknowledged a likely substantial spread over the inflation target in 2006. But it hopes to come close to its target of 4% in 2007. However, the NBR should consider the complicated nature of the accession year, when higher budget expenditure is going to take place. Even if budget policy would involve some crowding out of private expenditure (via larger tax income) a higher overall public budget expenditure would be quite probable owing to EU funds and the use of privatization receipts for infrastructure works. And more public budget expenditure would raise aggregate demand which, unless met by adequate domestic production, would harm disinflation and lead, *ceteris paribus*, to higher external deficits as well. Moreover, the intensity of crowding out is questionable when there is almost total capital account liberalization and credit is readily available. The Balassa-Samuelson effect would also impede bringing inflation down to cca. 4% in 2007. For these reasons the NBR has to be cautious of pinning all hopes on a low inflation in 2007 at the expense of missing the target considerably this year; it may turn out that missing the inflation target by a large margin would occur three years in row. And that would not enhance credibility. If early elections happen in 2007 they would also complicate the mission of the NBR to pursue a low inflation target in that year.

¹⁴ "Report on Inflation", NBR, Bucharest, February, 2006, pp.42

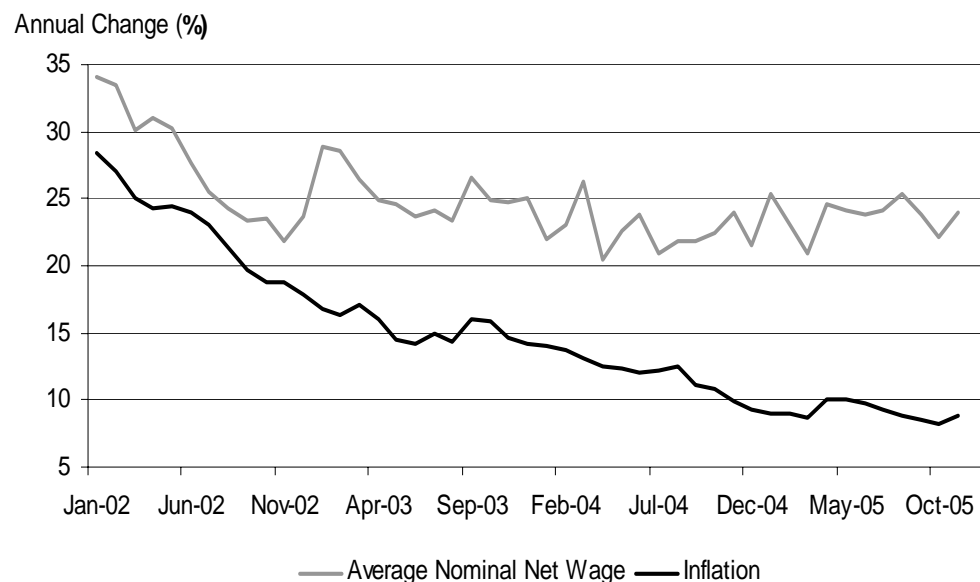
¹⁵ A higher level of the policy interest rate is not necessarily an optimal signal of policy tightening when there is a substantial discrepancy between the NBR's policy and intervention rates; in this case the intervention rate of the NBR would be a better indicator. For instance, the NBR has moved up its policy rate, to 8.5%, in February this year. What matters, however, in the end is the rate at which the NBR would consistently soak up liquidity from the market.

An optimal revision of inflation targets should have taken place across the 2005-2007 period in view of the shocks of last year. I would highlight again the wording of NBR's February report since it says unambiguously that the likelihood for inflation to be around 6.6%, in the basic scenario for 2006, is significant. As a matter of fact the Central Bank confirms what markets predict already to be more likely to occur this year. Unintended or not, it appears that a de facto revision of the inflation target for 2006 has occurred. And sooner or later the NBR would have to consider a revision of the 2007 inflation target as well.

Wage policy

For disinflation the control of wages is essential. There are two the aspects involved here: one is the advance of wages when these are not related to productivity gains and, consequently, exert inflationary pressures. As the graphic below shows the annual increase of the net average salary has stayed at a high level during the last few years although inflation has been coming down remarkably.¹⁶ The slowing down of industrial output suggests that this rise in salaries must have exceeded the labour productivity gains. Consequently, inflationary pressures operate on the side of salaries. Another aspect is wage indexation, which may worsen inflation expectations. Preferably, indexation should occur only once a year. The NBR is right to emphasize this issue for the success of disinflation.

Graph 1: Average nominal net wage and inflation



Source: Laurian Lungu

¹⁶ The rise in the real net salary was 4.7% in 2002, 10.1% in 2003, 10.6% in 2004 and 14.7% in the first 11 months of 2005. (Laurian Lungu, "Inflation Targeting: record and prospects", Ziarul Financiar, 13 February, 2006)

The public budget

The execution of the public budget has ended with a 0.8% deficit in 2005 (table 3). The low deficit is due primarily to a sharp rise in VAT and excise revenues, which has been brought about by higher consumption and imports. A budget rectification in early 2005, that has involved, unfortunately, a severe curtailment of capital expenditure, is to be mentioned in this regard as well (capital expenditure has gone down from 3.3% of GDP in 2004 to 2.8% in 2005 –table 3).

Table 3: The consolidated public budget (% GDP)

	2003	2004	2005*
Total revenue and grants	29.8	29.6	29.4
Tax	28.2	27.9	27.8
- Profits	2.3	2.7	2.6
- personal income	2.8	3.0	2.1
- VAT	7.2	6.9	7.9
Expenditure	32.1	30.7	30.2
- wages/salaries	4.8	4.9	5.6
- subsidies/transfers	14.1	14.0	13.7
- capital	3.5	3.3	2.8
- interest	2.1	1.3	1.2
Overall balance (cash, including grants)	-2.3	-1.1	-0.8

Sources: official statistics and IMF data; * preliminary

Though the public budget presumes a deficit of -0.5% for 2006 some of its underlying premises are questionable; I am referring to GDP growth and inflation, some envisaged expenditure (rises in salaries that are not yet budgeted), an anticipated rise in VAT revenues in particular. Therefore, a budget rectification would have to consider a revision of these premises.

Budget execution has to remain tight in 2007 in order to support disinflation. Nevertheless, the financing of infrastructure projects has to be increased. And special attention has to be given to raising the capacity to absorb EU funds. As mentioned above, the 2007 public budget would undergo a "shock" on both the revenue and the expenditure sides when EU funds and their co-financing are included. Privatization receipts (which would make up a so called National Development Fund) would add to available higher public budget funds.

The payment of the contribution to the EU budget and co-financing of EU funds would involve 2-2.5% of additional budget funds; in order to avoid a significant rise in the public budget better tax collection and a broadening of the tax base would be more than welcome; as some suggest, a rise of some taxes would be unavoidable in the period to come

in order to keep the budget deficit below -1.5% of GDP in the accession year¹⁷.

The “macroeconomics of a higher budget” is a key policy topic for the Government and the Central Bank; unless properly designed and programmed higher budget expenditure can re-inflate inflation and lead to higher external deficits. The composition of budget expenditure would matter tremendously in this regard. For it is one thing to spend more money for higher wages; and it is quite different if the funds are used to build up infrastructure and better education, as well as for the reform of the pension system. The more the public budget crowds in domestic production the better. For this to happen public money has to be spent on infrastructure wisely.

4. EU commitments

Romania has to make better on its commitments to the EU. Likewise, Romanian elites have to define national interests better, in concrete terms, which should be pursued before and after accession. Privatization and the regulation of public utilities are to be mentioned in this respect. The decision not to privatize Romgaz with a strategic investor is quite appropriate. Likewise, the regulation of privatized utilities has to be more effective and prevent abuse of market power. Whereas the pricing in domestic markets of oil and gas products should force Romanian companies to become competitive (according to the rules of the game in the EU) a much less compelling argument can be used about the price level when it comes to household consumers. In a country where many individuals can hardly make ends meet financially and there is domestic production of oil, gas and hydropower, a EU level pricing of energy for households is questionable, economically, socially and politically; a gradual rise in prices (that should go beyond the accession year, in pace with the rise in average incomes) makes sense.

The EU has its specific supranational interests; but it is also a constellation of national interests which, often, are conflicting. And this reality poses numerous challenges to national decision making.

5. The international milieu

The international environment would continue to be influenced by major uncertainties which are rooted in global imbalances and the economic fallout from geopolitical conflicts.

Economic stagnation in Europe and elsewhere, as well as the rise of China, India and other Asian economies, would prompt countries

¹⁷ If such a rise occurs and it involves an increase of the VAT (instead of the flat tax) that would deliver a heavy blow to NBR's objective of bringing inflation down to below 5% in 2007. While a rise in the flat tax would be an embarrassment to the Government.

(including the EU and its individual member countries) to seek more protectionism as a means to defend domestic markets (The grid-locked Doha trade round speaks for itself).

The price of basic commodities (oil and gas, in particular) would continue to be under the pressure of the rise of Asian economies and supply side bottlenecks. These circumstances would affect the Romanian economy.

6. Summing up and a few policy guidelines

a. The slowdown of output, as an outcome of supply side shocks, should be a matter of serious concern. The months to come would illuminate if this is a short-term adjustment phenomenon, or longer term effects are at work. An in depth analysis of how changes in relative prices and other shocks have affected industrial sectors and companies is badly needed. This analysis would help both policy making and heads of companies. For the growth of output to pick up again it is essential that fixed investment rise steadily and new technology absorption is intense. Much is in the hands of the private sector since it produces almost 70% of GDP.

b. Productivity gains have been subsiding lately and the slowdown in the growth of exports¹⁸ indicates that the appreciation of the RON and high wage rises are taking their toll. If this appreciation would continue as and after Romania gets into the EU, and efficiency gains are not adequate, a major competitiveness problem might develop --as a sort of a *Dutch disease*. Local firms have to respond to this challenge by cutting redundant costs, by absorbing new technology, by mergers and fusions that create synergies and enhance capabilities. Industrial relocation (from West to East) could help the Romanian economy, but there is no implacable engine at work here. Low wages are far from supplying the critical ingredient when competition is increasingly global.

c. Supply side shocks and bank credit driven consumption, plus the wealth effect due to the RON's appreciation, have led to higher external deficits in 2005. This tendency can not continue for long were FDI inflows and efficiency gains insufficient. The Government and the NBR have to be on alert on this tendency. Monetary and budget policies have to stay tight while the composition of budget expenditure has to focus on capital goods (infrastructure) and education. It is commendable that the share of R&D in the public budget has gone up to 0.4% of GDP (from 0.27% in 2005); companies themselves have to invest more in new technologies.

d. Budget and monetary policies have to stay tight in order to continue disinflation and contain the rise in external deficits. Monetary policy needs to be more consistent while the budget policy should focus on crowding in domestic production --via infrastructure development and better

¹⁸ Some exports have a heavy loan content. In a way, such loan-based exports inflate the volume of exports and imports. They can disappear as sudden as they appear.

education. Wage control is a critical factor in going on with disinflation in view of the record of subsiding productivity gains in recent years.

e. Inflation targeting has been started under unfavorable domestic monetary conditions, that complicate its conduct and hang to inflation a cluster of adjacent objectives (avoid exchange rate over-appreciation, encouraging credit in domestic currency, etc). Therefore, monetary policy would continue to face major trade-offs

f. Impediments for monetary policy are also entailed by the "macroeconomics of a higher budget" in the accession and subsequent years. In order to avert/mitigate a "budget shock" in the accession and subsequent years there is need for better tax collection and a broadening of the tax base; a rise in some taxes might be inevitable in order to keep the budget deficit below -1.5% in the accession year.

h. Infrastructure is revealing itself as a development bottleneck. Together with education it can propel development. There are substantial EU funds and privatization receipts to this end, but these resources need to be capitalized by good projects and good practices. The Government has announced that the Bucharest-Brasov highway would be financed by the public budget in order to avoid delays. However, since this route benefits on a high traffic it would be sensible to see whether private-public partnerships can be used in order to save public money for projects that can scarcely use private finance without state guarantees.

i. The logistics of the EU funds utilization is a formidable challenge for the Romanian government. Time is running out and too little has been done in terms of finding ways to circumvent the antiquated and impervious to change system. Hiring new people and a better pay is insufficient under the circumstances. 2007-2013 is, probably, the period with the largest EU budget funding potentially available to Romania. The Lisbon Agenda constraints plus the tensions between donor and recipients countries would likely reduce the funding after 2014. Unless Romania proves that it can absorb EU funds adequately longer term prospects for financial assistance would worsen.

JUSTICE

Reform shakes conservative establishment

2005 was an important year for the judicial reform in Romania. In March 2005 the new Government adopted an ambitious revised Strategy and Action Plan 2005-2007 to reform the justice system. Unlike previous strategies which dealt with broader institutional aspects, these documents were aimed at the judicial process itself, so they represent a significant step forward. These enhanced efforts aimed at completing judicial reform came as the combined result of two key factors. Firstly, the change in government in November 2004 produced a centre-right, reformist government, which included a Minister of Justice who had previously worked as a civil society activist and human rights lawyer for the Council of Europe. Secondly, the introduction of a safeguard clause regarding EU accession at the December 2004 European Council provided serious impetus, as reform of the judiciary came on top of the EU list. Failure to achieve standards in this area can attract a delay of the accession date from 2007 to 2008. The new legislation, the implementation of the old and more generally the whole reform met with tremendous opposition, highlighting the main problem of the Romanian transition: conservatives seem often to outnumber reformists.

The reform package passed in 2004 stripped the Ministry of Justice of many of its powers in order to entrust them to the elected body Superior Council of Magistrates (SCM). The Council was elected last December after an election in which heads of Courts were often the only candidates to run. The result was not an accountability body, but a representative body for the top management of the judiciary as it has been for the last decades. It was entrusted with full control over the recruitment, promotion and control of judges.

This body did not delay in positioning itself more like a defender of corporate interests than as a reformer and controller of the judiciary. Members insisted in keeping their double capacity as heads of Courts and controllers of the same Courts. They denied the mere existence of corruption within the judiciary and hired most of their staff from the Ministry of Justice. Tenth of employees of the Ministry, precisely those who had

been accused for years to have delayed reforms, followed the transfer of power from the Ministry to the Council and considerable delays were incurred on long discussed reforms, such as introducing clear standards for the evaluation and promotion of judges.

Following consultation with stakeholders a revision of the 2004 so-called three-law package on justice reform (Laws on the Superior Council of the Magistracy, on the Organization of the Judiciary and on the Statute of Magistrates) was submitted by the Government to Parliament in June 2005 and adopted after a vote of confidence. The 2004 laws have been criticized by Freedom House in the Nations in Transit 2005 country report for failing to provide an accountability mechanism for the newly empowered Superior Council of Magistrates and for the General Attorney office. In early July the Constitutional Court issued a majority ruling that 4 articles were unconstitutional. These were important articles. One provided that judges must retire at the same legal age with all employees, in an effort to open the system to younger magistrates. Despite not touching in any way on the Constitution the article fell, as it would have pushed into retirement the families of judges of the Constitutional Court as well. The Court also opposed that heads of Courts, appointed by the Minister of Justice under SDP are dismissed and open competition is held for these offices, allowing only for such competitions when the office became vacant. The strangest ruling was on the incompatibility of a position as SCM member, which was agreed it should become a permanent position, to another management position in the judiciary. The Court ruled that this exists only for the President and the vice-president of the SCM, leaving the rest of the members free to hold both offices. Pressure on some of them to solve this conflict of interest eventually led to the resignation of the SCM President and his replacement.

The disputed articles were subsequently revised and the package was promulgated in mid-July. The package retained many positive elements, and the legal framework now offers sufficient guarantees for magistrates' personal and institutional independence, although accountability mechanisms are still frail. The package puts individual and managerial accountability at the centre of the system and diminishes the power of the heads of Courts to hand cases to selected judges, a major source of corruption and influence traffic in the past. The revised legislation states that Chief Prosecutors can only allocate cases to prosecutors on the basis of clear and objective criteria such as workload and specialization and can no longer intervene in the activity of prosecutors subordinated to them.

The Civil and Criminal Procedure Codes were also amended in 2005 in an attempt of simplifying and speeding up the lengthy and complicated judicial procedures.¹⁹ A new Ethics Code for Magistrates was drafted by

¹⁹ The Criminal Procedure Code was not passed by the Parliament yet.

the Ministry of Justice together with the Superior Council of Magistrates in September. This code provided for the first time in a Romanian law that judges and prosecutors must not have cooperated with the former Securitate and must not be currently working for any intelligence agency.²⁰

2005 also registered the first significant budgetary increase for the judiciary (56 million EUR, representing an approximately 20% increase following two budgetary rectifications). The 2006 budget (403 million EUR) provides for further increase of approximately 12% (41 million EUR) for the overall budget of the judiciary, as compared to the 2005 rectified budget (362 million EUR). This ensures the financial resources for the implementation of the ambitious Reform Strategy adopted in 2005.

The most serious problem in the reform of the judiciary remains the conservatism of the High Courts, which assemble, due to seniority requirements, mostly aged former Communist judges. The Constitutional Court has for more than half of its members' magistrates with a previous social-democratic affiliation, from ministers to advisors, although the Court is supposed to be apolitical. SCM members have six years appointments, while members of Superior Courts have life tenure. Despite efforts from the government side, implementation of reforms is bound to remain a challenge.

Anticorruption pushed despite political opposition

Romania in 2005 enjoyed a cleaner central government, and better anticorruption plans and laws were passed. But each concrete step was fought fiercely between reformers and conservatives and so the progress achieved was smaller than popular expectations.

The Freedom House audit of the anticorruption strategy provided a basis for the new action plan against corruption. The audit was organized at the request of the December 2004 European Council and published in March 2005. The first immediate practical consequence of an audit showing how irrelevant the activity of the National Anticorruption Prosecutor (NAP) had been in the previous years (this special office created to fight grand corruption had succeeded in more than two years to prosecute only a political advisor and an assistant magistrate as top people) would have been the dismissal of the head of this agency. The man had close links with SDP, having his own brother as a MP of this party.

²⁰ Before appointing a magistrate, the SCM has the obligation to check with CNSAS (the Council for the Study of the Former Securitate Files) if the respective magistrate had ever cooperated with the former Securitate. At the same time, upon appointment, the magistrate has to sign a declaration stating that he is not working for any intelligence agency.

However, his dismissal had to wait until the judicial reform package was passed by the Parliament, as the passage introduced a mechanism of holding accountable the two major Prosecutors, the General Prosecutor of Romania and the National Anticorruption Prosecutor. Amazingly enough, the package on the judicial reform of 2004, although supervised by a plethora of experts, had missed entirely to create such an accountability mechanism. SDP fought fiercely to defend the Anticorruption Prosecutor, voted against the judicial reform and used all its influence in the Superior Courts to halt the reform. When a NAP prosecutor finally summoned enough courage to investigate the scandal of SDP transcripts (as they recorded interventions to shield political friends from anticorruption prosecution), the Constitutional Court expediently ruled that the NAP was not even allowed to investigate MPs, although it had been created two years in advance with precisely the purpose of dealing with top level corruption. NAP was then turned into a Department within the General Prosecutor's Office (NAD), so to bring again top politicians under its lawful authority. In March 2006, however, this revision, previously passed by government as an emergency ordinance, so taking immediate effect, came for parliamentary approval and was stalled. It needed an intervention by the President of Romania who negotiated with the parties to push the ordinance through Parliament. An effective NAD clearly makes many MPs feel very uncomfortable. It kept NAP has been the beneficiary of considerable investment, and unlike ordinary prosecution offices it has the judiciary police under its direct control. The competences of the new NAD have been narrowed to only the highest corruption cases where the bribe is over EUR 10 000 or the material damage exceeds EUR 200 000. The NAD will also be responsible for investigating certain customs-related offences and tax evasion where the damage exceeds EUR 1 million as well as offences against the European Union's financial interests. A new NAD head was eventually appointed after the whole management was sacked or left in August. But months of anticorruption were lost simply fighting to empower this office to do its job.

The new appointed head, a young prosecutor, Daniel Morar, has embarked in a reshuffling of NAD's operations. Between January 1st and December 31st, 2005²¹, NAD charged 744 defendants among which a former MP, 4 magistrates, 6 lawyers, 38 employees in law enforcement agencies, 8 high level employees in the central administration, 17 officials and high level employees in the county and local administration. An important businessman and liberal politician, Dinu Patriciu, with close ties to the Prime Minister, is also investigated, as well as the former Prime Minister Adrian Nastase. Mr. Nastase is a collateral, although not innocent, victim of the compulsory statements of wealth. He was always on the public payroll (a minister in Romania has been paid an average of about 500 euros throughout transition(\) and has difficulties in explaining how he amassed millions of euros. Courts sentenced 325 defendants between January 1st and December 31st, 2005, including one magistrate, 34 employees in law enforcement agencies, 16 custom employees, 5

²¹ Since the establishment of NAPO until December 31, 2005, NAPO indicted 1809 defendants.

officials in county or local administration and 6 bank directors. NAD investigates members of Parliament, other high level dignitaries, magistrates, police officials, customs officials, mayors and local barons.

Overall, there has been an increase in the political will to tackle corruption. The Minister of Justice, Monica Macovei, as well as some new offices, such as the Office for Money Laundering and the Office for Fiscal Evasion showed real commitment to fighting corruption. The Office of Money Laundering even opened an investigation on the PM's bank accounts, a step showing that these offices are *de facto* independent. Other measures designed to fight high-level corruption entered into force in 2005 and early 2006, including the removal of the *de facto* immunity of former Ministers in April 2005 and the adoption of new templates for wealth statements in May 2005. These statements are public and posted on the Internet sites of government agencies. A project to create a national integrity agency which would check the validity of these statements and enforce conflict of interest regulations is under work. In April 2005 Romania abolished also the criminal immunity of public notaries and bailiffs.

The Freedom House audit criticized the lack of coordination of the many bodies fighting corruption. In one of its most spectacular findings, the audit showed that control agencies such as Financial Guard or Audit Court have sent less than 10 cases to NAP for further investigation since its creation in 2003, and those did not lead to any prosecutions. Despite more political will to increase coordination in 2005, it has not happened yet. Ministries continued to compete among themselves to create anticorruption offices or host the future Agency for Public Integrity. The most ambitious project belongs to the mammoth Ministry of Internal Affairs and Administration (MAI), which pushed a bill through Parliament in May 2005 on the creation of its new anti-corruption structure within the Ministry, called the Directorate General for Anti-Corruption (DGA), which will control the staff working in central and regional structures, notably the police, border police and gendarmerie. Critics allege that the structure is based too much on the secret service staff of this ministry, people with roots in the former Securitate of Ceausescu, but everybody agrees corruption within law and order agencies needs special tackling.

A 2005 EBRD-World Bank survey (BEEPS) of businesses in South-Eastern Europe found that Romania made significant progress from 2002²². Bribing is down, and costs of registering and operating businesses have decreased considerably. Romania is under the current East Central European average on bribes as a share of annual sales, after scoring nearly the double of European average in 2002. The trend is clearly positive.

²² See report at <http://siteresources.worldbank.org/INTECAREGTOPANTICOR/Resources/BEEPS2005-at-a-glance-Final-Romania.pdf>

Administration

ADMINISTRATIVE TRANSPARENCY INCREASES SIGNIFICANTLY

DISCIPLINARY MECHANISMS, HOWEVER, LAG BEHIND

The mass of taxpayers can control those who govern and manage their country in two ways. First and foremost, we have the elections, if they are free and fair, as they provide a vertical control. Those who cannot govern well are bound to lose the elections. However, in developed countries, the change of governments brings on some changes of policies, but not of the overall government style, of governance, as it were. There are a number of reasons why this change doesn't happen: 1) the government has accurate performances, but the people are dissatisfied because of some political, social or economic matter (inflation rate, unemployment etc.); 2) the politicians in various parties come from the same social layer, which may have different ideologies, but not different philosophies about the way the state should function; and 3) most of the administrative activities are run by the professional civil servants, the bureaucrats, who do not change with every election cycle, no matter what party accedes to power. This is why vertical control is, sometimes, not very satisfactory. In substantial democracies it is also corroborated with a horizontal control, exercised by the courts of law, anti-corruption agencies, the disciplinary commissions of the Parliament of Government, the media, civil society.

In such societies as Romania, where a whole process of rebuilding is in progress, after the communist era, there is a risk that some of the institutions won't work at the same time, that there are no effective election committees, the courts do not issue accurate and timely rulings, there are no managers with lots of experience to secure the good functioning of the state irrespective of political problems. The administration reform in such countries has been rightfully compared to the building of a ship, which is already floating and started on at full speed. The public transparency laws in this case, like the free access to public information and transparency in decision-making laws in Romania also have another purpose than that of democratizing Romanian

administration, namely the very practical purpose of making any citizen or private entity with access to information about the governance a willing and volunteer instrument of controlling the administration, when all other controls seem to fail. This is why we need mandatory wealth statements, open to the public, not only to state agencies, because we rely on the public to exercise this control, in an age of immaturity of the state.

The Romanian Academic Society has proposed a number of controls to be exercised in this respect, mainly articles in laws and official regulations, which have been adopted. In 2002, one year after the FOIA Law 544/2001 should have started to be implemented, SAR conducted a wide survey in the public sector, to see the way this implementation was going. In 2006, the final year before EU integration, if no accidents happen on the way, SAR repeated and expanded this research²³, in order to see the way administration evolved over the past 3 years. We monitored the implementation of the transparency laws, among which some of the provisions which were introduced in the law texts upon SAR's initiative, especially the mandatory annual activity report to be issued by each public institution, to be used as an instrument of controlling the use of public funds. The results of this survey should be seen as a test of the implementation capacity of our administration, as a measure of its maturity. The extent to which EU funds have been spent and this survey can be considered a diagnosis of the administrative capacities in Romania.

This annual report on governance will not discuss political problems, whose impact on accession is indirect or very weak (anybody who is ruling would have the same problems), but the structural issue of the state maturity and capacity. We made a survey of 500 public institutions in order to get these results. The detailed structure of the sample is presented in figure 1.

Figure 1. Surveyed Institutions

Type	No.
City Halls	85
County Councils	42
Prefect's Offices	42
School Inspectorates	42
Employment Offices	42
Labor and Social Solidarity Departments	12
Police Inspectorates	42
Town police sections	6
Prosecutor's Offices with District Courts	40

²³ The method used in this survey was that of the face-to-face questionnaire applied to the individuals in charge of implementing Law 544/2001. The sample was made up of 500 public institutions, and the valid no. of questionnaires was 453. We selected 96 cities, of which 40 county seats, and the criteria for sampling institutions were: development region, county seats, second largest city in the region after the county seat, two communities with more than 30,000 inhabitants, and towns under 30,000 inhabitants.

Prosecutor's Offices with Appeal Courts	6
Regional Customs Offices	10
Appeal Courts	16
Health Insurance Houses	42
Financial Guard	42
Ministries	15
Governmental Agencies	13
SMC	1
Parliament (Senate and Chamber)	2
Total	500

The results of this survey seem pleasing (see Figure 2). The Implementation of the FOIA Law has progressed a lot, and now almost each public institution in most county seats has a civil servant in charge if implementing this law. The number of requests for information based on this law exploded once the law became more and more known. Administrative of legal complaints increased several times, when the request for information is denied. *Unfortunately, very few of these complaints seem to be solved administratively, therefore the number of suits against the administration also rose.* Secrecy is not the only invoked reason for denying the request, most of the time it is a matter of administrative issues. More than 2/3 of the surveyed institutions now have a list of information ex officio, as compared to the 16% in the first year after the law came in force. The deconcentrated offices of the Ministry of Labor and the Prefect's Offices rank first among the institutions with lists of ex officio information (Figure 3). The opposite ranking belongs to the Prosecutor's offices and town halls. Only 2/3 of the ministries have such a list, although the law should be implemented 100% in the central administration. The residential environment also brings on significant differences, with a higher implementation rate in Bucharest (77%), a good rate in county seats (74%), and a considerable lower one in small towns (62%).

Figure 2. Main Developments 2003-2006

	2002 %	2006 %	Trend
Percentage of hired FOIA officers (in charge of implementing Law 544)	75	97	Very positive
Requests for information received	22	82	Very positive
Administrative complaints	4	12	Positive
Complaints in court	1.6	10	Positive
Percentage of ex officio information lists available for immediate submittal	16	73	Very positive

Figure 3. Existence of the List of Information Ex Officio according to the types of institutions

Institution	Percentage of implementation
City Halls	71
County Councils	87
Prefect's Offices	90
Prosecutor's Offices with District Courts	60
School Inspectorates	68
Police Inspectorates	73
Employment Offices	80
Financial Guard	63
Health Insurance Houses	76
Prosecutor's Offices with Appeal Courts	50
Appeal Courts	83
Labor and Social Solidarity Departments	64
Regional Customs Offices	80
District Courts	78
Ministries	64
Governmental Agencies	78

Even for the more qualitatively challenging requests provided by the law, as, for instance, the issue of a public activity report of the institution, the progress is important, although of poor quality. There are no standards for this report, so that, in some cases, the reports of the pres desks regarding communication and not the activities of the whole institution have been presented as activity reports. The methodological annexes of Law 544 provided very brief standards, which are not implemented. Usually, these reports don't include the goals and don't make any connection between the implemented activities and the expenditures. As a positive aspect we should note the posting of such reports on the websites, especially in Bucharest, but the current situation of using the report as an instrument of control is highly problematic. Only half of the institutions which claimed they produced such a report were able to show it to our operators, and the same percentage of institutions organized public annual presentations of their activities, where the report was also presented. In this respect, the situation is better in county seats (49% made such activity reports public), as compared to Bucharest (38 %) or the rest of the country (28 %).

The quantitative analysis shows much better results, and the administration has made a lot progress with regard to transparency. The situation of the activity reports however, shows that the administration is confused, very few know what objectives to follow, and a legal or promotion advisor gets the task of producing an annual report (there are many departments which draft this report, which shows lack of consistency in implementing the law). Transparency seems to have grown a lot faster than administrative competence.

The situation of administrative measures against corruption is similar. Corruption prevention using administrative tools is vital in countries where corruption is very much spread, and the justice system very inefficient.

Although people complain about corruption, especially with regard to the magistrates and police (about 60% believe they are corrupt or very corrupt, according to the POB 1/2005), but also to city hall staff and local councilors (40%), referrals and complaints were received only for 0.2% of the cases. Although the staff says the complaint procedures are clearly posted, the National Institute for Administration reports similar figures with ours. According to INA, 0.2% of the civil servants were punished last year for conflicts of interest, incompatibilities or corruption complaints. Only 77 civil servants, i.e. 0.01% of the total number, received financial punishments of any kind. Most of these sanctions have not been connected to complaints from the citizens. If the number of complaints rose when it became clear that the system works, the administration's self-regulating capacity is clear only in the number of 81 referrals sent about behavior issues of the civil servants last year. Either there is no corruption, or people know that nothing good can come from complaining to the administrative supervisors.

The situation is a little better for our sample, which also includes magistrates and the Ministry of Interior staff. 74% of these units had no complaints about corruption; punishments were given in 15% of the cases. Generally speaking, the administration's capacity of regulating its integrity problems without appealing to the slow and costly mechanism of the courts of law is very weak.

This very brief picture of Romanian administration triggers a couple of immediate recommendations:

1. It is absolutely necessary to have detailed instructions for a meaningful activity report which is likely to reflect the activities of the institution accurately, and to be used as a control tool. This means that a reporting standard should be created, and instructions as to how to collect information from within the administration.
2. It is also necessary to have the same publicity mechanism which was used for Law 544 employed for corruption prevention. Presently, the public does not trust disciplinary committees, or doesn't know about them, and they prefer to keep a low profile. However, the activation of an efficient mechanism of administrative complaints would be saving the justice system from cumbersome and costly procedures and increase public trust in the administration. Instead of having some vague promotion campaigns against bribery (which is practiced because otherwise nothing would be solved), it would be better to promote the administrative anti-corruption referral system. This system needs to be activated, however, as it is dormant at the moment.
3. Transparency should be pushed forward in certain areas lagging behinds, like the Prosecutor's offices, the Financial Guard and other highly hierarchical institutions, or those which were militarized until recently. Transparency is the best tool to help these institutions improve their performance.

EUROPE

The Absorption of EU Funds

A MEASURE OF CAPACITY IN THE ADMINISTRATION AND THE PRIVATE SECTOR

Absorbed into other areas of policy where the move is more rapid and spectacular (e.g. the judiciary), we tend to forget about the momentous struggle of the Romanian public administration to absorb EU funds on the pre-accession instruments, as well as to prepare itself for the structural funds which are to come after 2007. This is, actually, a struggle with our own (limited) management capacity: to create and manage projects, to be transparent and spend the money according to strict regulations, without waivers and improvisations, both in the public administration and in that part of the private sector which is eligible for EU funds. This is a unique administrative saga in the modern Romania, as there has never been such a high level of foreign assistance available in our country, with appropriations of almost 2% of the GDP in 2006, and about 5-6% of the GDP in the peak years 2009-2010, extended over such a long period.

All Romanian governments up to now have tried, in good faith, to achieve a higher rate of absorption for EU funds, as this is one of the objectives all parties agree on. However, all governments have been faced with the same problems, because the government can control and speed up only the inputs: building institutions, hiring staff, drafting strategies and, sometimes, identifying projects. But, since by the EU rules disbursement comes at the end of a project, if everything goes by the book, the ability to spend becomes an output indicator. Unfortunately, the road from inputs to outputs is where we get stuck.

In other words, political will, writing strategies and creating institutions with EU models are not enough anymore. Actually, the fact that EU funds come over us only shows more clearly the kind of weaknesses Romanian administration has had for a long time. Just like now, after the coming of the EU funds, capital improvements in Romania have always had their own distinct features, with passed deadlines and surpassed budgets, with adjustments along the way and permanent informal negotiations between the client and the beneficiary. This is the institutional culture of punctual derogations and weak budget constraints, of contracts with orientative value only, which the Balkan-style communism only reinforced.

Spending money on pre-accession instruments

It is difficult to provide a short and comprehensive indicator of performance in this domain, and it will not be very useful anyway, especially because of the complicated structure of assistance available. The absorption and impact issues vary a lot from one program to another, depending on the nature and size of these programs, on the institutions which manage them or the types of beneficiaries. The fewest but largest projects are those in **ISPA**, the instrument which provides funds for large transportation and environment infrastructure; it is easier to measure progress in such projects. The situation in early 2006 is presented in Tab. 1.

Table 1. ISPA Situation in February 2006

<i>Total budget (UE+Ro), 2000-2006</i>	<i>2,880 bn. €</i>	
<i>Total EU grant</i>	<i>2,160 bn. €</i>	<i>75%</i>
Contracted funds	1 bn €	35%
Payments made to the projects	340 mil €	12%
The first projects were approved in 2000. The last projects will have to be approved in 2006. The final payments are to be made by mid-2010.		

Source: EC Delegation

Of course the percentages must be interpreted cautiously: only part of them were approved in the first 1-2 years, it takes time to prepare works contracts subsequently, so we can safely say that it is natural to have more payment accumulated towards the end of the period. However, the level of payments is quite low and the pace of signing contracts is not very satisfactory, either, because, at least theoretically, we are more than halfway down the period when the money can be used.

The other two pre-accession instruments, PHARE and SAPARD, have higher absorption rates. For the former, this rate has always been around 95%. But the instruments are difficult to compare because their structures vary a lot. **PHARE**, the oldest and largest of the three instruments in terms of funding²⁴, is also the most diverse, because it includes capacity building technical assistance and exchanges in various fields, cross-border projects, but also the "Economic and Social Cohesion" component, an anticipation of the Sectoral Operational Programs and the Regional Operational Program after 2007. Because of its various interventions, local private and public infrastructure, grants for SMEs, HR investment, social and civil society projects and so on, PHARE allowed more internal freedom to shift funds between components.

SAPARD, the assistance for rural development that anticipates the large similar program to be funded from CAP after 2007, stands witness for the

²⁴ The approximate proportion of annual allocations between PHARE, ISPA and SAPARD is 3:2:1.

different type of problems encountered with the measures targeting the local governments and the private agro sector. Interest is high in small rural infrastructure projects (roads and water supply/sewage works), and this component was over-subscribed by 100%. In contrast, for the other measures, mostly focused on farms and private entrepreneurs, the authorities did not get the answers they expected from the potential beneficiaries, due to lack of information, lack of matching funds, or maybe because of administrative hindrances in accessing the funds or, simply, because of the weaknesses of the private agricultural sector.

Finally the new EDIS system (*Extended Decentralization Implementation System*) which must be applied in the management of funds after 2007, transfers more responsibilities on the Romanian side than the current one (DIS). There won't be thorough examinations and step-by-step approvals of the European Commission after 2007, only the global, strategic control, and some random monitoring, which means that the moral hazard is increased if the tracking of contract implementation stages by the Romanian side is weak.

Systemic Issues

In a meeting with politicians, experts and officials involved in the administration of EU funds in Romania, organized by SAR at the end of 2005, the following list of systemic problems in program implementation were discerned.

- Generally speaking, individual projects or sub-measures of a program are developed separately as stand-alone goals, and not as part of a larger economic development strategy. When two lines of funding are implemented at the same time, potential synergies are lost because the programs are not correlated in terms of mechanisms and priorities²⁵.
- Rigid appropriation systems can hinder the efficient allocation of resources, flexible matching funds or private-public partnerships;
- The preliminary selection of projects by the Romanian side is often poor, because of insufficient technical capacities. This leads to some incomplete projects being sent to Brussels (with unavoidable delays, back and forth circulation and the need to add more documents);
- The contracting authorities in charge with the projects or those which have to assist beneficiaries are oftentimes passive, in a defensive mood. Engaged and proactive project management, focused on finding solutions for the unpredictable problems which are inevitable, efficient management of funds or management based on objectives are rare birds in public institutions.
- There is still no strong system of institutional incentives to take into account the maintenance and operational costs at their real value in a capital improvement project. Generally speaking, the usefulness of

²⁵ An interview with the official of RDA North-East, referring to the grant schemes for SMEs and professional training/retraining programs.

the capital investments tends to be underestimated, and the associated costs underrated, which leads to an exaggerate number of such requests.

- There is limited expertise in Romania for the certification of project payments for ISPA, SAPARD or in the investment part of PHARE, in the public or private sector. After 2007, together with the multiplication of the available funds, this lack may bring on payment delays.
- There is a deficit of qualified human resources, a high employee turnover and relatively small salaries in the public institutions implementing or supervising the EU projects. Over the past several years, the average time spent by a well-qualified youth in such an institution was 2-3 years, followed by a move to the private sector. This means the leaving individual took with them all the tacit experience and investment made through training. There are some signs of improvement in 2006, and we hope to have more stable staff after the government decided to raise the salaries of the staff involved in EU projects.
- Although everybody admits that any existing institutional resource, with competence and expertise to work on foreign projects should be fully used in order to improve absorption, this doesn't happen in real life. There are well established and operational structures like FRDS²⁶ which couldn't find a place in the architecture of EU funds, because they were not subordinated to one of the ministries which will receive management authority after 2007. Because FRDS is not part of such a governmental hierarchy, it was not included among the intermediaries or even among the implementers, although it has a wide network of community facilitators and is well experienced in managing domestic and foreign public funds. This is, probably, the only public agency with people deployed in the field that can go to poor communities and help them directly to generate and manage projects throughout the management cycle – which SAPARD, for instance doesn't have. Moreover, ministries without any capacities now strive to create territorial offices from scratch, but only in several county seats, and they cannot find experienced staff.²⁷

As if this was not enough, some additional complications will come after 2007:

- a. The absolute level of available amounts will increase gradually until the peak years 2009-2010, as against the pre-accession time;
- b. The funding rules will be applied more drastically, which hasn't been the case until now, when the status was more relaxed for "pedagogical" reasons. One of the most important rules is the "n+3"²⁸, meaning that the money allocated in one year must be committed to

²⁶ The Romanian Social Development Fund, a public agency running small projects in isolated rural communities, with money from the state budget or the World Bank.

²⁷ _ *The Analysis of Absorption Capacity of Structural Funds in Romania*. Pre-accession Impact Studies series III. European Institute, Bucharest. January 2006.

²⁸ N+2 until the European Council of December 2005.

a project in almost 36 months, or they are lost. Until now, in some big projects, the actual commitment time was $n+4$, so the money would have been lost if the rule had been applied to the letter.

Encouraging Developments

As the government was dutifully warned about the absorption problems, it sped up the preparations lately, especially at the institutional level. Sustained efforts have been made to finalize the structures of fund management bodies, especially at the subnational level. As we said, the remuneration policy for the staff involved in EU projects has changed; steps have been taken in SAPARD to assist the farmers who want to access funding on the accredited measures; and it looks like the portfolio of projects for the environment is well set for the next years.

The most promising developments are those made at the *European Council in December 2005*, when certain decisions were made which will smoothen the absorption of funds in Romania and Bulgaria. These decisions did not change the actual amounts – and, therefore, were not much discussed by the public in the two countries – but the allocation rules, helping to ease the real bottlenecks. This is actually a matter of increased flexibility and reducing the burden of the matching funds for the poorer EU members.

Recommendations

Therefore, there is much to do in order to provide Romania with a good absorption of EU funds, and part of these measures are already on the government's agenda. Our proposals would make up a list of simple, inexpensive measures which could be put in practice starting next week, without much institutional change.

- The key word should be *transparency*: not only with regard to strategies, the content of projects and the initial budgets, but also regarding the implementation and the performance indicators, physical and financial. So far, no such information is available to the public from the Romanian authorities.
- In order to understand the area of EU funds and identify issues earlier, the Romanian authorities must apply the good practice of commissioning independent assessments of the status of absorption, globally or for each field of activity.
- The concerns and uncertainties at the subnational level (regional, county, local) must be considered with greater attention, as many future beneficiaries of structural funds still don't know how the funding will be carried on, or what the institutional arrangements will be.
- Horizontal, inter-sectoral communication – among post-2007 POSs in EU terms – is not the main strength of Romanian administration. Lack of coordination won't affect the absorption figures in these "soft" areas too much, but they may reduce the final impact of the projects.

- Generally speaking, it would be recommended to put to better use the current institutions, which already have experience in running programs, and be more conservative with the building of new institutions from scratch.

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